No.s 278 - 282

IN THE

Supreme Court of the United States

October Term, 1945

RECONSTRUCTION FINANCE CORPORATION, INSURANCE GROUP COMMITTEE, CENTRAL HANOVER BANK AND TRUST COMPANY, TRUSTEE, UNITED STATES TRUST COMPANY OF NEW YORK, TRUSTEE, GUARANTY TRUST COMPANY OF NEW YORK, TRUSTEE, and THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, TRUSTEE,

Petitioners,

vs.

THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY, ET ALS.,

Respondents.

(And Other Cases as Shown on page i)

PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

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TITLES OF CASES IN WHICH THIS PETITION IS FILED

RECONSTRUCTION FINANCE CORPORATION, INSURANCE GROUP COMMITTEE, CENTRAL HANOVER BANK AND TRUST COMPANY, TRUSTEE, UNITED STATES TRUST COMPANY OF NEW YORK, TRUSTEE, GUARANTY TRUST COMPANY OF NEW YORK, TRUSTEE, and THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, TRUSTEE,

Petitioners,

vs.

THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY, ET ALS.,

Respondents.

[Number 2906 below]

SAME

vs.

THE DENVER AND SALT LAKE WESTERN RAILROAD COMPANY, ET ALS.,

Respondents.

[Number 2907 below]

SAME

vs.

CITY BANK FARMERS TRUST COMPANY, TRUSTEE, ET ALS.,

Respondents.

[Number 3106 below]

SAME

vs.

THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY, ET ALS.,

Respondents.

[Number 3107 below]

SAME

vs.

GUY A. THOMPSON, TRUSTEE, ET ALS.,

Respondents.

[Number 3108 below]

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Key to Record References

The record as printed pursuant to stipulation for the purposes of the Petition is cited R..... except that the original Submission Pamphlet included therein is cited by its original paging as Subm. Pamph. .....

The unprinted transcript is cited as follows: *(i)* the transcript before the Circuit Court in No.'s 2906-7 below as Tr. I.....; *(ii)* the transcript before the Circuit Court in No.'s 3106-8 below as Tr. II .....; and *(iii)* the transcript of the proceedings in the Circuit Court as Tr. III.....

Petition for Writs of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit

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The Solicitor General, on behalf of Reconstruction Finance Corporation, and other counsel named below on behalf of the respective other petitioners, pray that writs of certiorari issue to review the decrees of the United States Circuit Court of Appeals for the Tenth Circuit entered on May 10, 1945, reversing orders of the District Court for the District of Colorado approving and confirming a plan of reorganization under Section 77 of the Bankruptcy Act for The Denver and Rio Grande Western Railroad Company (the Debtor) and The Denver and Salt Lake Western Railroad Company (the Subsidiary Debtor).

RFC and Insurance Group Committee are large holders of senior securities involved in the reorganization. The other petitioners are indenture trustees under senior mortgages. The questions are of general concern in railroad reorganizations touching (*i*) the relative treatment of senior and junior creditors and (*ii*) the relative authority of the Interstate Commerce Commission and the courts.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 233) is not yet reported except in C. C. H. Bankruptcy Law Service at ¶ 55,329.

The opinions of the District Court (Subm. Pamph. 187 and R. 213) are not yet reported except in C. C. H. Bankruptcy Law Service at ¶ 54,562 and ¶ 55,008.

The reports of the Interstate Commerce Commission (Subm. Pamph. 29, 98, 113 and 151) are reported in 233 I. C. C. 515, 239 I. C. C. 583, 254 I. C. C. 5 and 254 I. C. C. 349.

JURISDICTION

The decrees of the Circuit Court of Appeals were entered on May 10, 1945. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925 (28 U. S. C. Section 347).

QUESTIONS PRESENTED

1. Whether, under the priority rule, a Circuit Court of Appeals may modify a reorganization plan under Section 77 so that, while forcing senior bondholders, in satisfaction of their claims, to take new common stock at its par value, though there is no assurance that it can ever be sold at any price approaching that amount, it makes substantial awards of cash and new senior securities to holders of old junior bonds. This question, so far as relating to cash, is presented with respect to (*i*) cash on hand at the effective date of the Plan and the time of the Commission's finding, (*ii*) cash thereafter received before consummation of the Plan and (*iii*) cash that may be received after consummation.

2. Whether, consistently with the rule of administrative discretion, a Circuit Court of Appeals, though admittedly without power to change the Commission's determination of the amount and character of the new securities, is nevertheless free to require substantial changes in the effect of the Plan by direct allocations of cash. This question also is presented with respect to cash of each of the three kinds referred to in 1. above.

3. Whether a Circuit Court of Appeals, though concluding that the Commission's "action . . . in setting up the capital structure . . . must be upheld", is nevertheless free to require substantial changes in the capital structure by:

(*i*) adding additional new junior securities because of the court's own view of future earnings;

(*ii*) adding additional new securities, apparently of senior grades, because of the periodic retirement of equipment trust obligations, in the face of an express provision in the Plan that such retirements should reduce the new capitalization by an equal amount; and

(*iii*) requiring the issuance of new securities, apparently of senior grades, that the Plan no longer contemplates since the provisions authorizing them have been excluded from the Plan in accordance with its terms.

4. Whether, despite Sections 1(28) and 77(a) of the Act and the decision in *Ecker* v. *Western Pacific R.*, 318 U. S. 448, 506 (1943), a reorganization plan under Section 77 must require collateral pledged for obligations of, but not owned by, the Debtor to be availed of before receiving new securities from the estate.

5. Whether a class of creditors, by an adverse vote, may bar confirmation of a plan, even though such creditors, as the most junior, are allotted all of the new capitalization that remains after provision for senior creditors.

STATUTE INVOLVED

The pertinent provisions of Section 77 are copied in the Appendix.

STATEMENT

1. *History of the Proceeding.*—The petition of the Debtor for reorganization under Section 77 was filed in the District Court for Colorado on November 1, 1935. After numerous hearings in 1936 and 1937 the Commission approved a plan of reorganization. For reasons not now relevant, it was disapproved by the District Court on March 7, 1941.

The Commission held another hearing in May, 1941, thereafter received certain further evidence taken in the District Court in 1942 and 1943, in addition to current financial statements,* and approved the Plan on June 14, 1943. After hearings, the District Court approved the Plan on October 25, 1943 and, after submission to creditors, confirmed it on November 29, 1944.

The Debtor appealed from both these orders. From the latter City Bank Farmers Trust Company, as Trustee for the most junior issue of bonds (the General Mortgage Bonds), also appealed. All appeals were disposed of by the court below in its opinion and decree of May 10, 1945.

2. *The Commission's New Capitalization.*—On the usual record, including detailed evidence on every factor relating to value for reorganization purposes, the Commission fixed a new capitalization. This is to consist of four classes of new securities of fairly conventional grades,** and also of (*i*) new collateral notes under which certain of these securities are to be pledged and (*ii*) outstanding equipment trust obligations to be assumed.

Annual requirements through dividends on the Preferred Stock on all securities to be publicly held or pledged under the notes are $4,487,015. This rises to a total of $6,649,449 if dividends are included on the Common at 5%.***

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*These were always available to it by stipulation: Tr. I 1967-68 and 2500.

**The most unusual feature is that the First Mortgage Bonds (due in 50 years) are to bear fixed interest at 3% and prior contingent interest at 1%. The Second Mortgage Bonds (due in 75 years) bear contingent interest at 4½%. The dividend rate on the Preferred Stock is 5%.

***This does not include equipment trust interest or interest on new securities originally provided for an issue (the Junction Bonds) since acquired by the estate.

Historical earnings are substantially less than this total. After Federal income taxes at an assumed rate of 35%, the average annual earnings for the whole period since 1920 are only $4,647,000.* After Federal income taxes as reported in those years, the corresponding figure is $5,314,000.** On either method of reflecting income taxes, nothing at all was earned for the new Common Stock in any year of the whole period except in the peak prosperity years of 1925-1930 and the extraordinary war years of 1942-1944.

In approving this liberal capitalization the Commission no doubt gave weight to new traffic sources*** and to large improvements to the property during reorganization,† but it noted a trend to serious increases in unit costs of operation†† and held that war-time earnings could not be counted on for the future.‡

3. *The Commission's Distribution of the New Capitalization.*—All the underlying bonds are required to step down, in greater or less degree, into new junior securities. For present purposes it is sufficient to observe that all but one of the underlying issues receive the major part of their claim in

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*Computed from annual statements of record (Tr. III 19-348 and 547). Minor accounting adjustments required by the Commission are reflected. The income tax rate is taken merely as an illustration and is applied as if the Plan had been in effect throughout the total period.

**Federal income taxes actually reported in the past are, of course, an inadequate measure of the future burden because (*i*) pre-war rates were lower than probable rates for the long-term post-war future, and (*ii*) the road was shielded from their impact by the deductions available under its excessive debt capitalization, which is now to be ended.

***Subm. Pamph. 158.

†Subm. Pamph. 118, 122, 157.

††Subm. Pamph. 44.

‡Subm. Pamph. 158-9.

new stock, and two of them receive between a third and a half of their claim in new Common Stock.*

The Commission, for all that, gave only a face amount of new securities equal to the old claim, finding that "compensation to the holders of these . . . issues . . . would be adequate under the provisions of the plan"** chiefly because of "the possibility of increased return permitted by the 4½-per cent income bonds, 5-per cent convertible preferred stock, [and] unlimited dividends on common stock."† There was no finding that Common dividends in any particular amount were probable or that the new Common had any particular value.

These allocations use all the new securities except about 10% of the new Common shares. This entire balance is given to the junior system issue, the General Mortgage Bonds. At its par value it equals 10% of the total claim of those bonds. The position of general creditors and stockholders was found to be without value.

4. *Utah Fuel Stock.*—The Debtor does not own the Utah Fuel stock and never has. It was pledged under one of the underlying mortgages (the Western Consolidated Mortgage) by the mortgagor company in 1901. Upon judicial sale, subject to that mortgage, in 1920, the railroad properties passed to the Debtor (then newly incorporated to receive them) and the equity of redemption of the Utah Fuel stock passed to The Western Pacific Railroad Corporation and Missouri Pacific Railroad Company. The latter companies, to protect their stock holdings in the Debtor in its 1924 reorganization, assigned their equity so that dividends on the Utah Fuel stock should be paid to the Debtor as long

*The details appear at Subm. Pamph. flyleaf.

**Subm. Pamph. 169.

†Subm. Pamph. 168.

as certain bonds should remain outstanding, but not thereafter, the assignors reserving "the ultimate beneficial interest".*

The Plan leaves the Utah Fuel stock subject to disposition under the Western Consolidated Mortgage, by distribution to the holders of those bonds, either in kind or in proceeds of sale.**

5. *Junction Bonds.*—A section of the main line is owned by a subsidiary and leased to the Debtor. For the bonds outstanding on that section the Commission awarded $2,758,333 of new First's and Income's. But the Commission's jurisdiction over those bonds had been questioned, for the subsidiary was not a party to any proceeding under Section 77. To avoid any delay of the Plan by controversy in this regard, the Plan provided:

> "In the event that it appears to the judge that the consolidation of the Junction presents difficulties which may delay consummation of the plan in its application to the other interests, the judge may order consummation of the provisions of the plan other than those applicable to the distribution of securities to the Junction bondholders and the Junction consolidation." (Ct. R. 10,141; Subm. Pamph. 2)

This controversy was renewed in the District Court. By an order of September 16, 1943, it caused the Debtor's Trustees to purchase, and hold, the Junction Bonds.

The Commission construed this order as an exercise of the reserved power to exclude the Junction Company from

*Tr. I 3171, at p. 4. In event of foreclosure of the indentures securing those bonds, the equity of redemption was to be sold and the proceeds to be applied to payment of those bonds, any surplus to be divided among the assignors (*id.*, Article Fifth).

**Subm. Pamph. 20-21.

the Plan and thus did not submit the Plan to the holders of the Junction Bonds for their acceptance or rejection.*

The Plan provides that the amounts of new securities shall be:

> "... subject to reduction ... as equipment obligations or *other liabilities* are paid or reduced ..." (Subm. Pamph. 94, italics added.)

City Bank moved the District Court to require redistribution of the securities originally provided for the Junction Bonds, or, failing that, to disapprove the Plan on that account. Both motions were denied.

6. *Equipment Obligations.*—After the effective date of the Plan on January 1, 1943, the Debtor's Trustees continued to meet the serial maturities of outstanding equipment trust obligations. Thus the aggregate amount outstanding has declined by $609,000 in each of the two years since the effective date of the Plan.

7. *Submission to Creditors.*—In accordance with Section 77(e), the Commission submitted the Plan, after its approval by the District Court, to creditors for their acceptance or rejection. It was accepted by each class except the General Mortgage bondholders, who rejected it by a substantial majority of the small proportion that voted.**

8. *Action of the Circuit Court of Appeals.*—The court below professed to follow the doctrines laid down by this Court that its task on review was at an end if there was "warrant for the action of the District Court" and that the determination of the new capitalization by the Commission was conclusive unless "it can be said as a matter of law

*Subm. Pamph. 28.

**21.6% voted and of those 79.33% were for rejection (Tr. II 158).

that the Commission used fundamentally erroneous methods of valuation or acted arbitrarily or capriciously," thus concluding:

> "An examination of the entire record leads to the conclusion that the action and the conduct of the Commission in fixing the valuation and setting up the capital structure is free from these infirmities, and that its action in relation thereto must be upheld." (R. 245)

When it came to dispose of the case, however, the court below so far departed from these doctrines as to reverse the orders approving and confirming the Plan and to require substantial increases in the total distribution made by the Plan, both in cash and in new securities. The court thus felt free to substitute its judgment on such matters for that of the Commission. Each of these modifications also depends on the assumption that senior creditors are paid in full when they receive new securities in face amounts equal to their claims, even though such securities are largely of junior grades, indeed largely new Common Stock that offers no assurance of ever being marketable at any price approaching its par value. This assumption was made without any basis in administrative action, for the Commission found only that the senior creditors were, in the whole context of the Plan, compensated adequately to legalize the limited participation by junior interests provided for therein. The specific decisions were:

1. In the view of the Circuit Court, taken in the face of the Commission's implicit findings and apparently without regard to the requirements for a fair return on the new securities after the effective date of the Plan, net current assets are excessive, so, on the above assumption of full payment of senior creditors, all such

"excess current assets" "must be distributed" among the General Mortgage Bonds, apparently by direct award of cash from the estate (R. 247-9).*

2. As a matter of the court's own appraisal (made without apparent reference to the mounting burden of unit costs), "excess war profits" would continue for the rest of the war period** and, though the Commission was entitled not to capitalize them, it must, on the above assumption of full payment of senior creditors, provide for the distribution of such profits to the General Mortgage Bonds. (R. 247-9)

3. As a matter of the court's own independent judgment, future earnings (apparently of the long-term post-war future) will probably be "greater . . . than anticipated in the plan" and "if such should be the case, they certainly belong to the General Bondholders and not to the Seniors, and the plan should bring this about." Accordingly, "an additional amount of a subordinate stock which would receive returns only from excess dividends" is suggested as the means to remedy the asserted defect, though the choice of means is left to the Commission. (R. 249-50)

4. "The value behind the securities" provided for the Junction Bonds, as the court enigmatically put it, must, since the Junction Bonds had been acquired and "the

*The words of the Circuit Court are not beyond the reach of question, but they seem to contemplate a distribution in cash, and that interpretation is reinforced by the court's holding that current assets, even if "excessive", need not be reflected in increased capitalization.

**As a matter of fact, Gross Income in the war years has been:

1942	$17,444,000
1943	12,305,000
1944	10,912,000

Source: Tr. II 353 (at p. 19) and Tr. III 556 (at p. 5).

Senior Bondholders had been satisfied in full", be given to the General Mortgage bondholders. (R. 251)

5. Since equipment obligations had been reduced by $1,218,000 in the two years following the effective date of the Plan, "the new securities set apart for the payment of this sum [actually the Plan provides for assumption without the issuance of new securities] will not be needed" so the "unused value" behind them must, the senior bondholders having already "been fully compensated", be given to the General Mortgage bondholders. (R. 251)

6. The value of the Utah Fuel stock, though not the property of the bankrupt, must be deducted from the total claim of the Western Consolidated Bonds before they receive any recognition in new securities, and, apparently, any new securities thus becoming unused must go to the General Mortgage bondholders. (R. 252-3)

7. The General Mortgage bondholders were, therefore, "reasonably justified . . . in rejecting the plan" (R. 253).

REASONS FOR GRANTING THE WRIT

Question 1.

PRIORITY RULE

(a) Distribution of Cash.

The criterion of "fairness" in reorganization plans has a manifold impact on the national economy. It governs the character of plans for reorganization of railroads under Section 77 and of other corporations under Chapter X of the Bankruptcy Act, 11 U. S. C. §§ 501-676. In doing so it measures the protection that will be received by senior creditors, who have agreed to forego any extraordinary profits in reliance on their right to be made whole in an actual and

realistic sense before any provision is made for junior interests. Since the criterion has that critical function in the final evaluation of securities, its actual effect, as distinguished from the words in which it may be proclaimed, will affect the flow of new capital and the terms on which it may be available.

There could be no precedent more obstructive to the general public interest in the orderly completion of the remaining reorganizations in this cycle, or of others in the future, than an award of cash to junior creditors while senior creditors are compelled to take new securities, in large part of junior grades and of doubtful value. Cash is a more certain means of payment than any new security. To the extent of the cash distributed, such an award transfers the risk of ultimate satisfaction from the junior creditor to the senior, in direct contradiction of the classic priority rule.

Read in its application to the facts of this case, the precedent becomes still more alarming, for it can be rationalized only on a mechanical rule of thumb that whatever may be the principal amount or par value of new securities is equivalent to a payment in cash of that amount. There is no pretense of any finding that the new Common Stock may be sold, now or at any foreseeable future time, at anything approaching its par value. Nor is there any evidence to assure such a result. The when-issued market appraises the new Preferred at about two-thirds its par value and the new Common at about one-third.* So on the basis of when-issued quotations, none of the underlying bonds that receive any of the new Common Stock will receive, from the aggregate of the

*Judicial notice of such matters may properly be taken: *Wallace* v. *Franz*, 68 F. 2d 313, 314 (C.C.A. 8, 1933), *In re Chicago, Milwaukee, St. Paul & Pacific R.*, 124 F. 2d 754, 762 (C.C.A. 7, 1941), aff. 318 U. S. 523, and *In re Chicago and North Western R.*, 126 F. 2d 351, 367 (C.C.A. 7, 1942).

new securities allotted them, as much as two-thirds of their total claim.*

The court below goes still further. It requires all net current assets presently on hand in excess of operating requirements, and all future prosperity earnings, to be channeled off to junior interests. This is in the face of the fact that it is only from such sources that the Commission's finding of adequate compensation to senior interests by the "possibility of . . . unlimited dividends" can ever be vindicated.

The decision below represents an abrupt departure from the realism of analysis on which this Court has insisted, into a jurisprudence of symbols where proposed securities are automatically the equivalent of cash at their stated value, irrespective of their nature and quality. This is the untenable premise on which the court awards cash to junior interests. The error of that premise deepens when it is followed, as here, without regard to, and indeed against the indications of, the earnings record. Its consequence, finally, is sheer confusion when the assets and earnings which alone might support such a value are diverted to others. So these three successive steps into error are of cumulative effect and threaten to unsettle the foundations of the full compensation doctrine.

This Court thus has an opportunity, in a clear and concrete setting, to give specific meaning to the generalized expressions in which full satisfaction of senior creditors' claims has heretofore been proclaimed as a condition precedent to lawful recognition of junior interests, and to illustrate the actual working of the criterion that determines when full satisfaction is received. Without such clarification the decision below may lead to serious abuses.

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*Computed on the basis of the peak prices recently reached. On the other hand, the District Court, speaking, as the context shows, of the long-term future rather than the exceptional conditions of war-time, said that the new Common Stock "has little or no value" (R. 220).

In another respect also Question 1. (a) presents a problem of public importance. It is one that has not been, but should be, settled by this Court. Section 77(e) provides that for the purpose of *excluding* junior classes, reorganization value and permissible capitalization shall be determined as of "the time of the finding" by the Commission. The obvious purpose was to provide some fixed date, like that of a foreclosure sale, as of which such determinations should be made, for the history of rate litigations moving forward to a new point of computation at each new stage of the proceeding* haunted the draftsmen of the Act.** By that token the same date must control for the purpose of *limiting* the realization of junior classes.† It was not competent, therefore, for the court below to consider the amount of working capital *after* the date of the Commission's finding, or any increase of working capital after that date, for the purpose of inquiring whether it included any sum that could be prudently distributed to creditors of any class. To do so is to defeat the Congressional purpose which is importantly related to the practicability of the whole reorganization process. The matter is of public concern not only from that point of view, but also for due recognition of the priority rule, because from the effective date of the Plan†† all earnings must be deemed applicable to the new securities provided for in the Plan.

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*See *McCart* v. *Indianapolis Water Co.*, 302 U. S. 419 (1938) and cases cited at p. 435, footnote 19.

**Cf. Hearing before the Committee on the Judiciary, House of Representatives, 74th Congress, First Session, on H. R. 6249, April 15, 1935, p. 8, et seq. and 316 et seq.; Craven and Fuller, "The 1935 Amendments of the Railroad Bankruptcy Law", 49 Harvard Law Review 1254, 1268-76 (1936).

†Were there to be implied any exception where changes of condition are so revolutionary as to void the plan in its entirety, that would surely not be applicable here.

††So close in time (January 1, 1943) to the time of the Commission's finding (June 14, 1943) that no significant change of fact intervened, and the two dates are therefore interchangeable for present purposes.

Clarification of these points would materially facilitate the administration of the Act.

So far, finally, as the court's opinion relates to earnings to be received after consummation of the Plan, it necessarily modifies the new capital structure itself (a question dealt with in 2. below), for distribution of such earnings can not be made except by first issuing some form of new security that would evidence the right to receive and would legalize the distribution as a matter of corporate practice.

(b) Distribution of New Securities.

The questions raised by the Circuit Court's award of cash to junior interests are also raised by its apparent award to them of new senior securities. In view of the action of the Debtor's Trustees in applying cash on hand after the effective date of the Plan to the payment of equipment obligations and the purchase of the Junction Bonds, the Circuit Court, again assuming full payment of senior claims, required that "The value behind these securities" be distributed to the General Mortgage bondholders. While these words are enigmatic ostensibly they contemplate that the package of new senior securities in question be delivered to the General Mortgage bondholders, for the full "value" behind those new securities would not be distributed by the delivery of other new securities of junior grade.

If the recipients of new securities under the Plan are entitled to the benefit of all cash on hand at its effective date and all cash arising from later operations, as we believe the Act intends, they are equally entitled to that benefit whether the cash remains on hand or is invested in property improvements or is applied to reduction of debt. This is the rule applied in the important Rock Island reorganization.*

**In re Chicago, Rock Island and Pacific R.*, D. Ct. S. D. Ill., May 14, 1945, not yet reported (except in summary form in C.C.H. Bankruptcy Law Service ¶ 55,368).

The decision of the Circuit Court denies either the major or the minor premise of that fundamental rule, and further encroaches on the doctrine of fair treatment by directing, apparently, that the consequent redistribution of new securities, even though they are of senior grades, shall be wholly to the General Mortgage bondholders.

Question 2.

Commission's Discretion As To Cash

The "fair plan" that is supposed to be "The end product of this reorganization system". (*Milwaukee Case*, 318 U. S. 523, 555, 1943) and for which the approving judgment of the expert administrative agency is the first condition, would be a mockery if it covered only the distribution of new securities, without regard to the distribution of cash. That is a prime factor in fair treatment, directly for its intrinsic value and indirectly as it affects the quality of the new securities.

The amount of working capital at December 31, 1942 was considered by the Commission (Subm. Pamph. p. 155) and relied on, with current earning power, for the expectation that

> "any probable amount of cash required for paying the remaining reorganization expenses and the refunding or payment of nonassenting Salt Lake bonds can be met from funds in hand."

On that basis the Commission cancelled an earlier provision for new money. But it evidently thought that there were no surplus funds prudently available for distribution.

That administrative determination is entitled to the same respect as if dealing solely with new securities, and it should not be competent for a Circuit Court of Appeals to set it aside except for reasons justifying a change of the new capitalization, which the court below held it had no power to

make. Otherwise the basis on which the Commission relied for the fairness of the Plan may be destroyed. This Court has not previously ruled on this precise question and we submit it is of such general importance that a ruling should now be had.

The Circuit Court of Appeals for the Second Circuit has ruled on it, properly holding that:

> "It is for the informed judgment of the Commission rather than for the courts to determine the sufficiency of any cash reserve to meet the uncertainties ahead" (*In re The New York, New Haven & Hartford R.*, 147 F. 2d. 40, C.C.A. 2, 1945).

A conflict thus exists among the circuits which is particularly undesirable in a field of such general interest. It should be resolved.

Substitution of the court's judgment for that of the Commission in such matters involves special elements of hazard to the public interest, for the courts have not the experience or the facilities to exercise an informed judgment on all the pertinent facts. Thus the court below, in speaking of "excess current assets", looks only to the dollar amount of the difference between current assets and current liabilities, wholly neglecting the important factor of their ratio, which has remained almost static.* Even more importantly, the court below disregards the payments required for a fair return on the new securities from the effective date of the Plan on January 1, 1943, though it is well known that upon the consummation of other important reorganizations large cash distributions have been made for interest and dividends retroactively from the effective dates of those plans. Reflecting such a return here (even on the minimum basis of 5% Common

*158% on December 31, 1942 and 159% on December 31, 1944.

dividends),* the current position of the property would have been as follows (in thousands of dollars at December 31):

	1942	1943	1944
Current assets	$21,025	$27,266	$21,765
Current liabilities	9,560	20,033	17,055
Net current assets	$11,465	$ 7,233	$ 4,710
Current ratio	2.20	1.36	1.28

The $4,710,000 as of December 31, 1944, compares with an improvement program requirement at that time of $7,000,000 (Tr. II 451). So in fact there is a serious deficiency in net position even without any provision for working funds and reserves. The extraordinary distribution to junior interests that the court below requires will, in such circumstances, prevent the orderly operation of any plan.**

Furthermore the ruling of the court below becomes a direct modification of the new capitalization when it deals with earnings to be received after *consummation* of the Plan, and is, in that respect, covered in 1. (*a*) above as to the priority rule and in 3. below as to the Commission's function.

Question 3.

Commission's Discretion As To New Securities

When a Circuit Court of Appeals, undertaking to follow the decisions of this Court on the important matter of the distribution of authority between judicial and administrative agencies, concludes that the Commission's "action

*Source: Tr. II 353 and Tr. III 556.

**Another illustration of the dangers of a partial view is found in the emphasis given by the court below to property improvements. It spoke of them as amounting to $43,000,000, but this was without any consideration of retirements and recorded depreciation and amortization during the same period. Reflecting all these factors, the net increase in investment was only $8,000,000 from the inception of the proceeding on November 1, 1935, to the effective date of the Plan on January 1, 1943, and an equal amount thereafter to the end of 1944. Source: annual statements (Tr. III 19-348 and 560).

". . . in setting up the capital structure . . . must be upheld", and then immediately requires extensive and important changes in that capital structure, we submit it has so far departed from the usual course of judicial review as to call for an exercise of this Court's power of supervision. Unless it is recognized that the principle adverted to by the court below, which has been laid down by the decisions of this Court in areas where "It is essential that Courts regard this division of responsibility" (*N.L.R.B.* v. *Link-Belt Co.*, 311 U. S. 584, 597, 1937), is effectively nullified in practice by a decision such as that below, the Congressional scheme can not be safeguarded.

These are the changes required by the court below:

(*i*) For one it requires a diversion of all "excess" future earnings to the General Mortgage bondholders, which of course can not be arranged except by the issuance of additional new securities, and probably securities of some additional class. This the court recognized by suggesting that the means should be "a subordinate stock which would receive returns only from excess dividends" (R. 250), subordinate, that is, to the Common Stock itself, thus requiring a limitation on its dividends and changing the whole character of the new capitalization. There can be no question that through such means the dead hand of past indebtedness would effectually throttle the financing abilities of the new company, the very evil, in banker dominated days, which it was a major purpose of Section 77 to outlaw. There could be no hope of equity financing amid the deluge of paper tokens that would thus be created, even by sale of the top class of new common stock, for its chances of generous participation in the good fortune of extraordinary years would have been sapped by its parasitic inferior, and its market appeal in all years correspondingly weakened.

(*ii*) Equipment trust obligations occupy, of course, a special status, since they are not long term debt, but afford

a customary means of serial payment for new equipment, progressively with its consumption by use, from cash covered by operating charges for depreciation. The Commission, therefore, customarily provides that the approved capitalization shall be subject to reductions in such obligations.* It did so here by unmistakable terms.** No new securities of any kind were provided for these equipment obligations, but they were to be assumed by the new company. The court below, however, again asserting a power to revise the new capital structure by an original exercise of its own discretion, directs that additional new securities, of an undesignated grade, be created for the General Mortgage Bonds in an amount equal to the reduction in equipment obligations accomplished *after* the effective date of the Plan. This overrides the lawful exercise of administrative judgment on the new capitalization. In view of the nearly universal use of equipment obligations, and the continual fluctuation of their amounts, either downward by serial maturities or upward by new purchases, the decision in this respect would, if followed as a general rule, greatly obstruct the completion of reorganizations.

(iii) Since the provisions of the Plan allotting new senior securities to the Junction Bonds have, upon the purchase of those bonds by the estate, been excluded from the Plan pursuant to its terms, there are no authorized but unused securities to redistribute, and in addition the Plan provides that the capitalization contemplated by it shall be "subject to reduction . . . as equipment obligations or *other liabilities* are paid or reduced." The Commission's caution in this re-

*E.g., *Chicago & North Western Railway Company Reorganization*, 239 I.C.C. 613, 628 (1940); *New York, New Haven & Hartford Railroad Company Reorganization*, 257 I.C.C. 9, 34 (1944); *St. Louis-San Francisco Railway Company Reorganization*, 257 I.C.C. 399, 421 (1944).

**Subm. Pamph. 2-3.

spect is understandable in view of the fact that this is the third reorganization of the road since the last war, and the further fact that the provision was inserted at the time of approving a substantial increase in the new debt. That the final result is within the Commission's power is evident from the fact (pp. 4-5 above) that even after this exclusion, historical earnings do not provide a fair return on all the new securities. In the face of all these circumstances the court below asserts authority to require the creation of additional new securities in lieu of those formerly provided for the Junction Bonds and contrary to the apparent meaning of the Plan.

This is the first time that any court has overridden the administrative judgment on the amount of the total permissible new capitalization. This inroad on the Commission's statutory authority in such matters is aggravated by the fact that in this case the Commission, out of concern to protect all railroad security holders, had already been liberal, more so than is its general practice.* The decision below requiring a further enlargement of such capitalization has, therefore, special elements of danger, not only for this property but also for the regulatory scheme in its general operation.

Question 4.

Accomodation Collateral

Since the Utah Fuel stock is not property of the Debtor, it is not subject to disposition under Section 77, for that

*The new capitalization in this case is larger than in the average of all other important railroad cases, whether viewed in relation to the largest earnings in any year of the decade 1930-1939 or in relation to the physical values found by the Commission. The facts from which this purely mathematical calculation has been made appear in the published reports of the Commission and may be judicially noticed. The trial court, with its large administrative experience with the property, was troubled on this score, saying ". . . it is very doubtful in my mind if the new capital structure is not too large" (Tr. II 467).

deals only with "the debtor and *its* property".* The Commission, therefore, properly left the Utah Fuel stock subject to pledge under the Western Consolidated Mortgage, in this respect following the precise pattern of the Western Pacific plan. There the Commission held that the plan should be so framed as

> "in no wise disturbs or alters the rights of the Reconstruction Finance Corporation and the Railroad Credit Corporation in collateral pledged with them by parties other than the debtor" (*Western Pacific Railroad Company Reorganization*, 230 I. C. C. 61, 102, 1938, and to the same effect at 233 I. C. C. 409, 432, 1939).

Accordingly, under the Western Pacific plan (233 I. C. C. at 453), which was sustained by the Court on this very point,

> "This collateral . . . was therefore left with the pledgees with its position unaffected by any direct action of the Commission" (*Ecker* v. *Western Pacific R.*, 318 U. S. 448, 506, 1943).

The effect of the decision was that The Railroad Credit Corporation received new securities in respect of the full amount of the Western Pacific bonds held by it, without reduction because of any estimated realization from collateral pledged with it by others, and retained its full rights in such other collateral. Later the District Court in charge of the properties permitted The Railroad Credit Corporation to retain the payments received by it on such other collateral, despite the allocations of new securities made to it in the plan, because

> ". . . the market value of the [new] securities is much less than their face value . . . and it will not be able to realize thereon enough to satisfy its claim . . ."**

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*Section 77(a), italics added.

***In the Matter of The Western Pacific Railroad Company*, N. D. Cal. S. D., No. 26, 591-5, June 21, 1944 (unreported). That is the case here, for, as shown above (pp. 12-13), the Western Consolidated bondholders receive, on the basis of when issued quotations, less than two-thirds of their total claim.

The Commission in this case scrupulously followed the Western Pacific precedent, for extra caution spelling out the powers of the pledgee rather than merely leaving them implicit as in the Western Pacific Case. In result the Western Consolidated bondholders remained free to realize on the Utah Fuel stock by future proceedings, though at that future time the owners of the equity of redemption would of course be entitled to limit any realization on the collateral so that the actual value of the total realization by the Western Consolidated bondholders would not exceed the amount of their claim.* But that is by no means to say that their allocation of new securities in the Plan must be reduced by any estimated amount of later realization on the collateral, as the court below insists, for that rule applies only to "property of the bankrupt"** and it is settled by this Court that the opposite rule applies to other property.† In cases like this it is the realization from other collateral that is limited, and not the realization by allocations of new securities from the estate.

The court below brushed these considerations aside, remarking that "There can be no question" but that the *estimated* value of the collateral must be deducted from the claim before any new securities are allocated. This is a decision so clearly in conflict with applicable decisions of this Court, and so likely, if left in effect, to blur the law on an important point of reorganization practice, as to merit review and correction.

Question 5.

Power To Confirm Despite Dissent

The decision below that the dissent of the General Mortgage bondholders precluded confirmation of the Plan is the

Merrill v. National Bank of Jacksonville, 173 U. S. 131 (1899).
**Section 1(28) of the Act, 11 U.S.C. Sec. 1(28).
†*Ivanhoe Building & Loan Association v. Orr*, 295 U. S. 243, 245 (1935).

first to that effect. Section 77(e) expressly authorizes confirmation after dissent if the court finds that (*i*) the plan "makes adequate provision for fair and equitable treatment" of dissenters, (*ii*) the rejection "is not reasonably justified" and (*iii*) the plan is fair and equitable and otherwise in accord with the statutory requirements. This power is important because it is the pivot of the Congressional scheme to eliminate private rights of veto.*

It has been urged by dissenters, and was urged here by City Bank, that the "not reasonably justified" phrase contemplates some more favorable provision than the basic canon of "fair and equitable"**. This would frustrate the purpose of the Act, for no plan could lawfully award any class more than what is fair and equitable, yet each class could veto it unless it did.

The court below does not adopt this dual standard, but leaves uncertain the exact grounds, and effect, of its decision.† The mere fact, however, that, in an area of the law so uncharted, the decision upheld a veto power without clear definition of its limits will tend to create confusion in the reorganization process.

This will be all the more obstructive because of the facts in this case that the dissenting class got all there was left after provision for senior classes and the gravamen of their complaint was that there is not more to distribute. It was the will of the Congress that permissible new capitalization should be fixed by the Commission, with an eye to the public interest, and not by dissenting security holders, whose attention may well be more narrowly focused.

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*1935 amendment to Section 77; Hearings before Committee on the Judiciary on H. R. 6249, 74th Congress, 1st Sess., pp. 15, 33, 35.

**Thus City Bank urged that a rejection is "reasonably justified", if honest, unless "the plan is so patently favorable to 'those rejecting it' that no reasonable person could refuse to accept it" (City Bank's brief below dated February 5, 1945 at p. 56).

†R. 253.

It is of importance in the administration of the Act that the novel implications of this decision be set at rest and a trustworthy standard supplied for exercise of the power to confirm despite dissent.

CONCLUSION

The decision below is a dangerous departure from doctrines clearly settled by this Court on the priority rule and the administrative powers of the Commission in railroad reorganizations. In addition it undermines both doctrines by other holdings on related questions that are of general importance and have not been, but should be, settled by this Court.

The questions are of public concern, not alone by reason of the substantial risk the decision raises of indefinite prolongation of controversies in this case affecting the rights of many people and already enduring for ten years, but even more for its disturbing implications in the whole field of corporate reorganization, involving economic problems of recurrent character and national importance.

We respectfully submit that the writ should be granted.

Dated July 31, 1945.

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APPENDIX

Excerpts from Section 77 of the Bankruptcy Act As Amended.

(a) . . . If the petition is so approved, the court in which such order is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located, and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a Federal court would have had if it had appointed a receiver in equity of the property of the debtor for any purpose . . .

. . . . . .

(c) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders; does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requirements of the law of the land regarding the participation of the various classes of creditors and stockholders; (2) the

approximate amounts to be paid by the debtor, or by any corporation or corporations acquiring the debtor's assets, for expenses and fees incident to the reorganization, have been fully disclosed so far as they can be ascertained at the date of such hearing, are reasonable, are within such maximum limits as are fixed by the Commission, and are within such maximum limits to be subject to the approval of the judge; (3) the plan provides for the payment of all costs of administration and all other allowances made or to be made by the judge, except that allowances provided for in subsection (c), paragraph (12) of this section, may be paid in securities provided for in the plan if those entitled thereto will accept such payment, and the judge is hereby given power to approve the same.

If the judge shall not approve the plan, he shall file an opinion, stating his conclusions and the reason therefor, and he shall enter an order in which he may either dismiss the proceedings, or in his discretion and on motion of any party in interest refer the proceedings back to the Commission for further action, in which event he shall transmit to the Commission a copy of any evidence received. If the proceedings are referred back to the Commission, it shall proceed to a reconsideration of the proceedings under the provisions of subsection (d) hereof. If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) hereof, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or re-

ports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided,* That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, or (b) that the interests of such class of stockholders will not be adversely and materially affected by the plan; or (c) that the debtor has pursuant to authorized corporate action accepted the plan and its stockholders are bound by such acceptance: *Provided further,* That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. For the purpose of this section the acceptance or rejection by any creditor or stockholder shall be in writing, executed by him or by his duly authorized attorney, committee, or representative. If the United States of America, or any agency thereof, or any corporation (other than the Reconstruction Finance Corporation) the majority of the stock of which is owned by the United States of America, is a creditor or stockholder, the interests or claims thereof shall be deemed to be affected by the plan, and the President of the United States or any officer or agency he may designate, is hereby authorized to act in respect of the interests or claims of the United States or of such agency

or other corporation. The expense of such submission shall be certified by the Commission and shall be borne by the debtor's estate. The Commission shall certify to the judge the results of such submission.

Upon receipt of such certification, the judge shall confirm the plan if satisfied that it has been accepted by or on behalf of creditors of each class to which submission is required under this subsection holding more than two-thirds in amount of the total of the allowed claims of such class which have been reported in said submission as voting on said plan, and by or on behalf of stockholders of each class to which submission is required under this subsection holding more than two-thirds of the stock of such class which has been reported in said submission as voting on said plan; and that such acceptances have not been made or procured by any means forbidden by law: *Provided,* That if the plan has not been so accepted by the creditors and stockholders, the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this sub-section (e): *Provided further,* That if, in any reorganization proceeding under this section, the United States is a creditor on claims for taxes or customs duties (whether or not the United States has any other interest in, or claim against, the debtor, as creditor or stockholder), no plan which does not provide for the payment thereof shall be confirmed by the judge except upon the acceptance certified to the court, of a lesser amount by the President of the United States or the officer or agency designated by him pursuant to the provisions of

the preceding paragraph hereof: *Provided further*, That if the President of the United States or such officer or agency shall fail to accept or reject such lesser amount for more than ninety days after receipt of written notice so to do from the court, accompanied by a certified copy of the plan, the consent of the United States insofar as its claims for taxes or customs duties are concerned shall be conclusively presumed. If the judge shall confirm the plan, he shall enter an order and file an opinion with a statement of his conclusions and his reasons therefor. If the judge shall not confirm the plan, he shall file an opinion, with a statement of his conclusions and his reasons therefor, and enter an order in which he shall either dismiss the proceedings, or, in his discretion and on the motion of any party in interest, refer the case back to the Commission for further proceedings, including the consideration of modifications of the plan or the proposal of new plans. In the event of such a reference back to the Commission, the proceedings with respect to any modified or new plan shall be governed by the provisions of this section in like manner as in an original proceeding hereunder.

If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts.